

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:2:PHI:TL-N-7095-00
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date: December 8, 2000

to: Lisa Woodman, Acting Group Manager E:1801
SBSE Territory 2; Philadelphia, Pennsylvania

from: DAVID A. BREEN
Senior Attorney

subject:

SSN: [REDACTED]
S.O.L. under I.R.C. § 6501(e)

This memorandum is in response to an inquiry from Revenue Agent Orville Surla, dated December 6, 2000. Our response is subject to mandatory ten day post review by National Office. If, after review, any modifications are required, you will be notified.

ISSUE

If a sole-shareholder of a valid subchapter-S corporation files a Form 1120 instead of an 1120-S, are gross receipts of the corporation considered in determining total income reported on the shareholder's return for computing the 25% omission of gross income under I.R.C. § 6501(e)?

CONCLUSION

Under the facts presented, for purposes of computing a 25% omission of gross income to determine if the six year statute of limitations applies under I.R.C. § 6501(e), the gross receipts of the converted corporation are not included in total income reported on the sole shareholder's Form 1040, because the existence of the corporation was never disclosed on the original Form 1040 or in a statement attached thereto.

FACTS

A valid subchapter-S corporation filed a Form 1120 instead of an 1120-S. The return reported \$[REDACTED] in gross receipts. The service center picked up the error, because there was a valid election on file under the same EIN and sent a letter to the corporation.

The Revenue Agent examining the sole shareholder's Form 1040 has identified \$[REDACTED] in unreported income based on an indirect method. The exact source of the unexplained income has not been identified. The normal 3 year statute of limitations for the 1040 expires on [REDACTED].

The taxpayer's 1040 return as filed reflected \$[REDACTED] of total income (Schedule C gross receipts and dividend income). The agent's adjustments increase total income by \$[REDACTED] to \$[REDACTED]. The shareholder did not receive wages from the corporation. No W-2 from this entity was attached to the return. Dividend income was only \$[REDACTED]. No Schedule B was completed.

The agent's specific question is whether the gross receipts on the incorrect Form 1120 should be added to total income reported by the sole-shareholder on his Form 1040 for purposes of determining if the \$[REDACTED] of unreported income is a 25% omission of gross income for purposes of I.R.C § 6501(e). We conclude they should not be included.

DISCUSSION

The normal three year statute of limitations under I.R.C. § 6501(a) is extended to six years if a taxpayer omits from gross income an amount in excess of 25% of the amount of gross income stated on the return. I.R.C. § 6501(e). However, if an omitted amount is stated on the return or disclosed in a statement attached to the return, that amount is not taken into consideration in determining the 25% omission test. I.R.C. §6501(e)(1)(A).

The purpose of the extended six year statute of limitations is to give the Commissioner additional time to make an assessment when a return contains nothing which would put the Commissioner on notice that a substantial omission has occurred. Where disclosure is made on the tax return, the need for additional time is obviated by the disclosure.

Congress manifested no broader [scope] than to give the Commissioner an additional two years (later extended to three) to investigate tax returns where, because of a taxpayer's omission to report some taxable item, the Commissioner is at a special disadvantage in detecting errors. In such instances the return on its face provides no clue to the existence of the omitted item."

(1958) *Colony Inc. v. Commissioner*, 357 U.S. 28

Gross income is the measuring standard for the two-prong determination of whether the six year statute of limitations applies. The first prong of the test is to determine omitted gross income; the second prong is to determine whether the omitted gross income was actually stated in the taxpayer's return.

This is an area where confusion arises from the fact that income tax returns do not directly show gross income. Certain deductions are reported on subsidiary schedules, so that only adjusted gross income, where applicable, and taxable income are shown. Only in the case of a taxpayer whose transactions are relatively straight forward does the "Total income" line on Form 1040, for example, show gross income.

B.N.A. Tax Management Portfolio, 501-

1st, 2 f/n 60.

A taxpayer's gross income includes the gross receipts (without reduction for cost of goods sold) of a subchapter-S corporation multiplied by the shareholder's percentage ownership of stock, only if the existence of the subchapter-S corporation is revealed on the tax return. If the existence of the subchapter-S corporation is not disclosed on the return, the shareholder does not include any of the subchapter-S corporation's gross receipts in the 25% computation.

I.R.C. § 1366 states that a shareholder's gross income from a subchapter-S corporation includes the shareholder's pro rata share of the gross income of the subchapter-S corporation. For purposes of computing whether the six year statute of limitation applies, the burden of proof is on respondent. Thus, where respondent failed to introduce partnership returns into the record, but relied upon the reported amount of distributive income from the partnership, the Court held that the six year statute of limitations did not apply. *Belcher v. Commissioner*, T.C. Memo 1958-180.

In Revenue Ruling 55-415, 1955-1, C.B. 412, the Service held that for purposes of the six year statute, "gross income" of a partner includes his proportionate share of the partnership's gross income.

The Court has consistently held that in the case of a partner, for purposes of computing the partner's gross income under I.R.C. § 6501(e), the partnership gross receipts are multiplied by the percentage partnership interest. *Rose v. Commissioner*, 24 T.C. 755 (1955), acq. 1956-1 C.B. 5, *Davenport*

v. Commissioner, 48 T.C. 921 (1967), *acq.* 1968-1 C.B. 2. See also, PLR 7952001 (August 21, 1979).

The above rule has also been applied to subchapter-S corporations. In *Roschuni v. Commissioner*, 44 T.C. 80 (1965), *acq.* 1965-2 C.B. 6, an 1120-S return was determined to be equivalent to a partnership return for purposes of applying the gross income reporting test of section I.R.C. § 6501(e)(1)(A).

It must be noted, however, that in the above cases, the existence of the flow-through entity, whether a partnership or subchapter-S corporation, was revealed on the face of the partner/shareholder's 1040. That is not the case in the situation Agent Surla describes in his memorandum.

In applying the above case law to the situation described, the \$[REDACTED] of gross receipts reflected on the 1120 is not included in the total income reported by the sole shareholder on his return, because the existence of the 1120 was not disclosed on the shareholder's Form 1040 or in a statement attached to the 1040. Even if the corporation had filed the correct return—Form 1120S—if the existence of the 1120-S was not disclosed on the return or in a statement attached to it, our answer would be the same. In your case, the unreported income (\$[REDACTED]) is greater than 25% of reported income (\$[REDACTED]). Therefore, the [REDACTED] year statute of limitations under I.R.C. § 6501(e) applies.

If you or Mr. Surla have any questions, please call me at 215-597-3442.

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cc: Area Counsel (SBSE2)